



# Tax News

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## *A shareholder borrows money*

Suppose that your client, Mr X, is the sole shareholder of Opco, an OBCA corporation. Opco has had a good run lately, and so it has \$100,000 sitting in its bank account doing not much of anything. Mr X would like to use the money to buy a boat or to make a down payment on a cottage.

Mr X doesn't like paying tax, but he also doesn't like paying for tax advice, and so he hatches a plan of his own to meet his cash flow needs in (what he thinks will be) a tax-effective manner. Opco, rather than paying a taxable bonus or dividend to Mr X, will *loan* the funds to Mr X. The receipt of funds pursuant to a loan is not income of course.

Mr X is smart enough to realize that he can't just take the money from Opco. He knows that, if the CRA starts asking questions, he will need to be able to prove that he borrowed the money and that he must repay it. He comes to you for help with documenting the loan. He suggests the loan should be repayable in, say, ten years. Mr X might even suggest that the loan should bear interest at some low rate and that Opco should take back security to bolster the argument that the loan is bona fide.

## *Shareholder loan tax consequences*

Of course, you will tell him that his plan won't work the way he hopes. S 80.4(2) of the *Income Tax Act* (Canada) (the "Act") requires Mr X to include a deemed interest benefit in his income in respect of the Opco loan. The amount of the benefit is equal to the prescribed rate (see <http://www.cra-arc.gc.ca/interestrates/>) calculated on the balance of the loan outstanding from time to time less any amount of interest paid on the debt. (If Mr X pays interest to Opco at a rate at least equal to the prescribed rate, then he will not be required to include any deemed interest in income.)

The prescribed rate these days is pretty low, and so Mr X might not be too worried about a deemed interest benefit. Mr X, however, will also be required to include the amount of the loan in his income if he does not repay it before the end of Opco's taxation year that follows the taxation year in which Opco advances the funds to Mr X (ss 15(2) and (2.6)).

Suppose that Opco has a March 31 year-end and no relevant taxation year is a short taxation year. If Mr X borrows money from Opco on November 30, 2016, then he will be required to include the loan in income if he does not

repay it before March 31, 2018. If Mr X fails to repay the loan, then he must adjust his 2016 tax return to report the amount of the loan as income. He will also likely be required to pay interest in respect of the resulting tax bill. (The only good news is that, if he included any deemed interest in income in any year under s 80.4(2), he will be able to request that the amounts be removed from his income. S 80.4(2) does not apply in respect of a loan included in income under s 15(2).)

## *Some other ideas that won't help*

Mr X doesn't help himself by borrowing money from Opco on November 30, 2016, repaying the money on March 30, 2018, and then borrowing the money again on April 1, 2018. As one might expect, the Act contains an anti-avoidance rule that is meant to catch any such series of loans and repayments. If Mr X's repayment on March 30, 2018, is part of such a series, then it will be ignored for tax purposes, and Mr X will still be required to adjust his 2016 tax return to report the amount of the loan as income.

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Mr X likely also doesn't help himself by borrowing the money and then claiming that it is an employee "housing loan". A housing loan can be exempted from the shareholder loan rules found in s 15(2), but the requirements of the exemption can be hard to satisfy. Among other things, Mr X will need to be able to show that a loan like the one he took was also available to arm's length employees on the same or similar terms and conditions. See *Mast v R*, 2013 TCC 309, which I discuss here: <http://jltax.ca/2014/03/housing-loans/>.

**Loans to family members**

Mr X might help himself by having Opco loan the funds to his wife or a child. The same rules respecting the loan that apply to Mr X as a shareholder of Opco also apply to any person who is "connected" with the shareholder. In general, "connected with" means the same as "does not deal at arm's length with". Naturally, Mr X's spouse and his child do not deal at arm's length with him for tax purposes. As a result, if they borrow from Opco, then they will need to account for any deemed interest benefit, and, if they do not repay the loan within the prescribed time, they will be required to include the amount of the loan in income for tax purposes.

Mr X might help himself by having Opco loan the funds to his wife or child if they are in a lower tax bracket. If they are in a lower bracket, then the tax they must pay in respect of the loan will likely be lower than Mr X's tax.

**Income averaging?**

Some advisers have suggested that a shareholder loan could be used as a kind of income-averaging tool. Suppose that Mr X's daughter is in law school. Her income while she is a student is likely to be low. Let's imagine

that her employment prospects are good, however, and so it is also likely that, soon after graduation, she will be earning a generous salary. Paragraph 20(1)(j) of the Act permits a person who was required to include the amount of a loan in income under subsection 15(2) to deduct that amount when he or she repays the loan.

Mr X's daughter, then, might borrow her law school tuition from Opco, pay relatively little tax on the amounts borrowed (because she is a student without much income) and then deduct those amounts when she repays them, presumably at a time when she is in a higher bracket.

**More pitfalls**

Mr X and his daughter, however, will need to watch out for a number of pitfalls including the following:

1. If the loan to Mr X's daughter is a part of a series of loans and repayments, then the daughter might be prevented from deducting any repayment of the loan.
2. If Mr X's daughter must wait many years to repay the loan, or if she must repay the loan before she has much income, then any benefit of the "income averaging" will be reduced or eliminated.

3. If bona fide arrangements for the repayment of the loan are not put in place, then the CRA might take the position that the "loan" was not a loan and was instead merely a benefit that Mr X wished to confer on his daughter. In that case, the CRA would likely include the amount of the "loan" in Mr X's income under ss 15(1) and 56(2) of the Act. Mr X would be required to pay tax in respect of the amount of the loan, and no deduction would be available for repaying the amount at a later date.

In fact, the latter issue should be considered carefully even if Mr X is the borrower. If the "loan" is not bona fide, then Mr X might be considered to have appropriated the amount rather than borrowed it, in which case the full amount of the loan will be included in Mr X's income, but Mr X will not be entitled to deduct any amount in computing his income even if he repays the loan. ■

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